BUSINESS LAW SECTION

Standing Committee on Cyberspace Law

Legal Issues Surrounding the Troubled Internet Company

by Denis T. Rice[*]
Founding Chair (1996-2001), California
State Bar Committee on Cyberspace Law
Howard, Rice, Nemerovski, Canady, Falk & Rabkin, P.C.
San Francisco, California

I. Introduction

A George Bernard Shaw character once said that "[t]he lack of money is the root of all evil." The same sentiments would likely be echoed by investors and management of many Internet companies, whether privately or publicly held. When equity markets were buoyant in 1998-early 2000, Internet companies had little problem raising money. In some cases, they were able to raise in excess of a billion dollars in a secondary offering.

Those heady days are over. In the current environment, cash is much harder to come by, and neither private venture capitalists ("VCs") nor public markets are willing to continue subsidizing operations with limited revenues and high operating costs. This is not to say that existing Internet companies are doomed; some are doing quite well, and e-commerce is here to stay. But management of troubled Internet companies and their creditors must have a firm understanding of the alternatives available, including retrenchment, revising the business model, obtaining new financing, merging, shutting down, or filing bankruptcy. At the same, those doing business with such companies, such as creditors and licensees, must be aware of the kinds of complications that can arise.

A. Different Types of Internet Companies

In discussing Internet companies, we should distinguish between at least three different types. One type of company develops essential software used in multiple applications by other companies that are engaged in B2B or B2C operations. Another, the telecommunications company, essentially provides connectivity to a base of subscribers. A third type has been often called the "dotcom," i.e., a company engaged in providing goods or services in the B2B and B2C spaces (including for this analysis B2G and P2P).

Of these three types of companies, the telecommunications company will have a network backbone and base of subscribers. The software developer and provider tends to have some valuable assets, namely its software. It may also have plants, facilities and other hard assets. The assets of the dotcom generally are more limited in value, including such things as a domain name (or names), customer data, some proprietary content and custom software, perhaps some intellectual property (*e.g.,* copyrights, trademarks, trade names and possibly patents), and contract rights (*e.g.* strategic agreements). The nature of the asset base in these companies will play an important role in their bargaining strength in any merger, sale or new financing, and in the process followed in event of bankruptcy.

B. "Hitting the Wall"

The downslope of the troubled "dotcom" company has seen several turns over the past 18 months since the stock markets began to recede. Initially, many dotcoms simply continued to burn through to the end of their cash reserves, without strategic retrenchment or change in their business plans. Their "burn rates" were often sustained by the belief that the next round of financing just a few more meetings away. But as venture capital failed to materialize, such

companies "hit the wall." They realized too late that their next payroll could not be met.

One example is Boo.com, the U.K. fashion retailer launched in November 1999, which filed for bankruptcy in May 2000. Boo.com was reported to have spent close to $135 million in investor money, at a burn rate of $23 million per month, including $38 million in offline advertising.[1] The Boo.com brand, web address, advertising materials and online content were sold for an undisclosed amount to Fashionmall.com. Its back-end technology, distribution and fulfillment systems and physical assets were sold to a British Internet technology firm for approximately $400,000, which was a fraction of the reported development cost.[2] A later example is Kozmo.com, an online company that delivered videocassettes, DVDs and other commodities to the customers' doorstep in one hour with no delivery charge.[3] It raised $280 million in venture capital from investors that included publicly-held companies like Starbucks and Amazon.com and sophisticated tech firms like Softbank of Japan. Kozmo announced on April 12, 2001, it would immediately cease all operations. Its website was shut down that same day, and it further announced that it would liquidate its assets.[4]

II. Retrenching and New Financing

To avoid hitting the wall, most troubled Internet companies try to retrench. Among the various steps they have taken are bringing in experienced management and shifting their business model. They try to reduce their burn rate by such steps as outsourcing manpower-intensive operations, reducing staff, cutting down on advertising, and reducing and consolidating office space.
They concurrently seek new funding, but in an environment that is increasingly difficult for venture capital. Before any of the collapsed 2000-2001 Internet companies conceded defeat, they made an effort at new financing. As discussed below, they have found that venture capital comes with more strings and at a higher cost than in the late 1990s.

A. New Venture Capital: Tougher Terms and Conditions

1. Lower Valuations

Troubled Internet companies learn that the cost of venture capital in 2001-when such funds are available at all-is far more than in 1999. First, company valuations are generally lower. One of the most ballyhooed IPOs of 2001 in the Internet arena was that of Loudcloud, Inc., founded by Marc Andreeson, founder of Netscape. Loudcloud was brought public at $6.00 per share, which was 35% *lower* than the last venture round of funding nine months earlier. Other 2001 IPOs have also been priced at substantial discounts to prior private venture rounds. All this fuels the downward pressure on company valuations. Thus, where a group of venture investors might ask for 15% of the Internet company in 1999 in exchange for a $20 million investment, it now might demand 45% in 2001. That effectively cuts the post-money valuation of the company by two-thirds, and generally results in a dramatic reduction in the value of preferred shares held by earlier preferred investors.

2. Higher Liquidation Preferences

In the area of liquidation preferences, terms are more onerous. Now, new investors usually seek a priority that returns them a multiple of their original investment per share in event of liquidation. Under these kinds of provisions, only after the new preferred stockholders receive their multiplied preference amount would holders of the common receive whatever remains. Moreover, the new venture investors frequently are asking for such priority in front of holders of the earlier rounds of preferred stock, as well as the common. Thus, some VCs are insisting on a liquidation preference of three or four times their investment before *any other investors,* including earlier preferred stock buyers in prior venture rounds, receive anything.

Even when the new preferred investors don't seek triple or quadruple their investment on liquidation, they may insist on so-called "double dip" preferred. Under this type of right (also called "participating" preferred), after holders of the new preferred stock receive back either the full amount or some multiple of their original investment upon liquidation, they then share equally with the common in any remaining assets. The new investors may also seek to add to their liquidation preference declared or accrued but unpaid dividends on the preferred.

The amount of liquidation preference is important to the troubled company because the preference typically applies to many transactions other than just statutory liquidation. More often in practice, it applies to an asset sale or a stock merger in which the company is not the surviving entity. In such a transaction, the preferred stockholders may elect to treat the sale or merger as a liquidation and thereby receive the liquidation preference before distribution of any proceeds from the sale or merger to the common stockholders. The preferred also have an alternative of converting to common prior to the sale or merger and receiving what the common stockholders receive. This election is made if the sale or merger is quite favorable.

3. "Full Ratchet" Anti-Dilution

Anti-dilution provisions are also tougher in the new environment. Typically, convertible preferred stock carries anti-dilution protection that results in an increase in the conversion ratio in the event that the Internet company subsequently sells any of its stock at a price lower than that paid by the preferred stockholder. The concept of dilution protection is that the number of common shares into which each preferred stock may be converted will be modified upon the sale of additional common (or other securities convertible into common) a lower price per share than the price being paid for the preferred by the venture investor. The modification is accomplished by calculating a new conversion price per share for the preferred stock.

The two principal methods of calculating the "conversion price" in anti-dilution protection are the "weighted average" and the "full ratchet." Prior to 2001, the weighted average, which is more favorable to the company, prevailed on West Coast financings. It typically does not have as harsh an impact on the conversion ratio as the "full ratchet," discussed below.

(i) "Weighted Average."

The weighted average adjusts the conversion price of the preferred stock in the following manner: the conversion price currently in effect is decreased as of the time of issuance of the lower price shares by multiplying such conversion price currently in effect by a fraction (i) the numerator of which is the total number of shares of common stock deemed outstanding immediately prior to the time of such issuance, plus the number of shares of common stock which the aggregate consideration received (or to be received) by the startup for the shares so issued would purchase at such conversion price, and (ii) the denominator of which is the total number of shares of common stock deemed outstanding immediately prior to the time of such issuance plus number of shares of common stock so issued.

Thus, by way of example, assume there were 1000 shares of common stock outstanding on January 1, 2001, prior to issuance of any preferred, and the startup sold 500 shares of preferred stock to investors at $1.00 per share, convertible at 1:1 into 500 shares of

common stock, or 33 1/3% of all common stock. Then assume 500 shares of common stock were subsequently sold at $.50 per share. The new conversion price on the earlier preferred would be 1750 ¸ 2000, or $0.875, and the new conversion ratio would be adjusted accordingly.

(ii) "Full Ratchet."

The preferred holders obtain a much larger advantage in anti-dilution under the "full ratchet" method of protection. In the full ratchet, the conversion price equals the most recent price per share of common stock sold by the company. Full ratchets have in the past have been found primarily in very early "angel" investor rounds, where the angel investors are not certain of the appropriate value to place on the startup, or in a later stage where the company is in distress and the prospect of a subsequent "down" round is quite real. Full ratchets became very uncommon in 1998-1999, but started to crop up increasingly in 2000-2001, when most second and third (or subsequent) rounds of financings have been so-called "down rounds," in which the company's preferred stock was made convertible at a conversion price substantially below the immediately previous round.

Thus, assume 1,000 shares of common stock were outstanding on January 1, 2001, at which time the company sold 500 shares of preferred stock to investors at $1.00 per share, convertible 1:1 into 500 shares of common stock, or 33 1/3% of all common stock. Then assume that 500 shares of common stock were subsequently sold at $0.50 per share. The new conversion price would be $.50 per share and the conversion ratio based on full ratchet would be $1.00 divided by $.50, or 2. This means the 500 shares of previously-issue preferred stock would be convertible into 1,000 shares of common stock, which on an as-converted basis would equal 40% of all common stock.

Even more important in its impact on the capital structure can be the fact that, where full ratchet provisions are used, the ratchet generally applies regardless of how many shares of stock are sold later at a lower price which triggers the ratchet. For example, even if only 100 shares of common stock were sold later in the preceding example at a per share price of $0.50, the preferred stockholder would still have the benefit of the 2:1 conversion ratio, the preferred stockholder would then own stock convertible into 1,000 out of a total of 2,200 shares of common stock, or nearly 45% of the common stock.

4. Veto Powers

Venture investors in 2001 also seek greater rights to veto more corporate decisions than was previously the norm. In 1999, the preferred investors might customarily ask for the right to veto major corporate transactions as sale of all or substantially all of the assets, a merger, liquidation or dissolution, or changes to the corporate charter and by-laws, by voting as a class on such transactions. Now, they also seek the right to block business transactions over a certain dollar amount or that exceed a certain duration.

B. Private Funding For Publicly-Held Companies: "PIPES," "Drips" and "Toxic Convertibles"

While VCs originally invested in Internet companies in order to put them in position to go public,

since 2000 they have used much of their cash to keep their troubled publicly-held portfolio companies from being delisted from Nasdaq. The different types of investment vehicles used to infuse new funding into publicly-held companies include "PIPES," "Drips," and convertibles, also sometimes called "Toxic Convertibles."

"PIPEs." "PIPEs" is an acronym for "private investments in public equities." Put simply, a PIPE involves purchase of common or convertible preferred stock of the publicly-held issuer by accredited investors in a private placement, with the issuer agreeing to file a registration statement so that the securities may be publicly resold. The registration statement is generally required to be filed with the U.S. Securities and Exchange Commission ("SEC") within a specified time period after sale of the PIPEs is closed, or (2) before closing of the sale, as a condition to closing. The price for the securities of the troubled Internet company is fixed at a level that includes a discount from current market value of its stock.

A PIPE can pose problems for the issuer's stock price, because of the large amount of stock that can potentially be sold (called "overhang"). In this scenario, it is not uncommon to see the stock tumble. In newer "structured" PIPEs, the issuer sells convertible debt or preferred stock with a conversion price that either varies or allows the purchasers to purchase additional shares if the price falls. Such structured pipes can involve the so-called "Toxic Convertibles" discussed below. Although a registration statement must be filed with the Securities and Exchange Commission ("SEC"), PIPEs can be completed much more quickly than a conventional public offering. For a dot-com company that is fast running out of money, time is of the essence.

"Drips." Drips essentially involve an equity line of credit under which the investors commit to purchase a certain amount of stock of the issuer over a set period, typically two to three years. For example, assume the troubled Internet company obtains a Drip for $24 million over a two year period; this means it would be allowed to sell $1 million in common stock to the investors every month. Thus, the stock in effect is "put," or "dripped," to the investors over a set period of time.

If the issuer in any given month does not need the money, or its stock price is very low, there is no requirement that it sell the stock. If the company needs more than $1 million for a month, there often is a clause that allows for larger dollar amounts, so long as there is adequate advance notice. Unlike a bank line of credit, the company pays no interest on a Drip. However, before a put can be made, a registration statement must be in effect with the SEC.

Convertibles, including "Toxic Convertibles." A convertible security issued privately may be either preferred stock or debt, which will have a higher priority than preferred stock in liquidation. The conversion price of the convertible is set at a premium to the public market price. The premium can range from 5% to 20%.

As discussed above, some convertibles have an ongoing variable reset provision; in other words, the conversion price of the security falls as the market stock price of the issuer falls. Others may have a floating conversion price. These "Toxic Convertibles" can set the stage for what is called the "death spiral." The fact that the convertible security has a conversion price discounted from the current market price gives the new investors a built-in gain, which in turn provides them an incentive to convert and sell the common shares rather than holding on to the convertible. These sales have a depressive effect on the market price, causing the price to decline, which in turn requires the issuer to issue additional stock pursuant to the terms of the transaction, as a result of either an ongoing price reset provision or a floating conversion price. Another scenario is for the investor to short the company's stock as the reset price falls and then swap the convertibles at the reduced price.

Either way, the investors profit, but the stock price ends up being hammered. Common stock can virtually never recover from a "death spiral." An example is eToys, which raised $100 million by way of a death spiral convertible in 2000. At the time, its stock traded at $6 and its market capitalization was over $1 billion. The stock kept spiraling down, and when it filed bankruptcy on February 28, 2001, it announced that its common stock had no value.

III. The Merger or Sale of Assets

A. General Considerations.

During 2000-2001, many troubled Internet companies sought merger with a stronger company. An example is CD Now, which marketed compact disks over the Web. It was sold to Bertelsmann in July 2000 for $117 million plus $24 million to cover debts.[5] In 2000, CMGI Inc. announced it would consolidate its 17 majority-owned companies into five to 10 operating companies to reduce costs and increase channel power. Many dotcoms tried desperately to find a merger partner before going bankrupt. Some were successful, most were not.

When stock of Drkoop.com dropped 96% below its high, it hired an investment bank to explore strategic financing options. In August 2000 it received a rescue package of venture capital that required control of the company to be ceded to the new investors. On August 29, 2001, it announced the acquisition of the operating assets of a Detroit-based home care provider (IVonyx) and a change of its business strategy to become a provider of diet supplements and other products as well as information.

APBNews.com, a crime news site, fired its staff of 140 in 2000 after it failed to find a partner to bail it out.[6] Some staff stayed on without pay, hoping for rescue by a "white knight." The company's chief executive, Marshall Davidson, said that investors were looking more skeptically at dot-com companies: "APB Online was in the midst of its third round of financing in March when the market's valuation of Internet companies drastically declined."

Since the market downturn of 2000, it has been increasingly difficult for most Internet companies to merge or sell. Part of what has deterred mergers is the belief that dotcoms were still overpriced. "Potential acquirers are often not interested in paying for brand, plant or technology, they have all that. What they want are the clients," said the, CEO of DLJdirect, an online brokerage, "Why pay $2,000 a customer when you believe you'll only have to pay a fraction of that in a few months time?"[7]

Frequently, the merger of two Internet-related companies merely postpones the demise of both. A company with promising technology but little revenue may acquire another company that has revenues. Subsequently, the revenues turn out to be short-lived, particularly advertising revenues, and the combined enterprise collapses. In some cases, the acquirer begins loaning operational funds to the other company, but the latter's operations never make a profit and when it goes under the acquirer is dragged down as well.

B. Whether To Sell Assets Outside Bankruptcy

Initially, the typical dotcom and its creditors sought to avoid formal bankruptcy proceedings. Such proceedings were seen as ill-suited to Internet businesses because, as remarked in a major legal newspaper in the San Francisco Bay Area, such a company's "stock in trade was electrons, and there are simply few assets or intellectual properties to dispose of."[8] UCLA law professor Kenneth Klee observed that failed Internet companies "close their doors, sent out a letter to their creditors, return the leased furniture and equipment, give the keys to the landlord and cry in their Anchor Steam [a local San Francisco beer]; they never file for bankruptcy."[9]

However, there are risks involved in selling or otherwise disposing of assets outside of bankruptcy. If the company files for bankruptcy within one year after the sale, the sale may be set aside by the Bankruptcy Court.[10] In addition, almost all states in the U.S. have fraudulent conveyance acts. These acts forbid transactions in which insolvent or under-capitalized debtors receive less than "reasonably equivalent value" for asset transfers. Unsatisfied creditors can set aside transactions under these statutes if they can meet three conditions. First, they must be able to identify the asset transfers. This can be difficult in transfers of intellectual property like source code, customer information, or trade secrets. Second, the court must have jurisdiction over the

parties to whom the assets were transferred. Third, the creditors must prove insolvency or undercapitalization at the time of the transfer.

If actual or constructive fraud is proved, the purchaser can be required to return the property to seller in exchange for a lien (to the extent of the value of the consideration paid by the purchaser for the assets). If the purchaser lacked good faith, the court can order return of property without the purchaser being entitled to a return of payment. Unsatisfied creditors have greater incentive to challenge a non-bankruptcy sale of assets if the sale does not produce sufficient consideration to pay off all outstanding obligations. Consequently, prospective buyer's may be reluctant to buy the assets without Bankruptcy Court authorization.

C. Are Domain Names "Property"?

A number of court decisions have held that domain names are not property, but a contract for services. Three cases so hold: *Lockheed Martin Corp. v. Network Solutions,* 194 F.3d 980 (9th Cir. 1999) ("*Lockheed*"), *Network Solutions, Inc. v. Umbro, Int'l, Inc.,* 529 S.E.2d 80 (Va. Supr. Ct. 2000) ("*Umbro*"), and *Kremen v. Stephen Michael Cohen, Network Solutions, et al.,* United States District Court for the Northern District of California, case number C-98-20718 JW PVT ("*Kremen*").

In *Lockheed,* the Ninth Circuit affirmed summary judgment in favor of Network Solutions on a claim that Network Solutions' refusal to cancel various domain names was actionable on a theory of trademark infringement. The Court rejected the argument that Network Solutions processed a tangible product in the form of a domain name, and ruled that Network Solutions provided only a *service.* It compared NSI to the U.S. Postal Service, i.e., NSI translates the domain-name combination entered by an Internet user to domain the registrant's IP address and routes the information or command to the corresponding computer. *Id.* at 984.

In *Umbro,* the Supreme Court of Virginia held that domain names should be considered services rather than property, and hence could not properly be garnished.

Umbro sought to enforce a judgment against a Canadian firm by garnishing the only "property" that it held in the United States, namely 38 Internet domain names registered with Network Solutions, Inc. In its garnishment proceeding, Umbro named Network Solutions as garnishee. Network Solutions asserted that it held no garnishable property belonging to the Canadian firm. The circuit court found that domain names constituted a "new form of intellectual property," and that the names should be turned over to the registry of the court for sale by whatever means the sheriff's office deemed appropriate.

On appeal, the Supreme Court of Virginia acknowledged that the right to use a domain name is an intangible asset, but that the asset was only a contractual right to use a unique domain name for a specified period of time. The court found the relationship formed between Network Solutions and its registrants was analogous to that between a satellite television provider and a customer with a prepaid subscription. It held that a domain name registration is the product of a contract for services, hence not appropriate for garnishment.

In *Kremen,* the court agreed with Network Solutions' position that a domain name was not tangible property and hence was not subject to claims for conversion and breach of bailment.

1. In Rem Provisions of the Anticybersquatting Consumer Protection Act ("ACPA")

The ACPA was made effective in January 2000. It provides for "in rem" jurisdiction over actions against Internet domain names. It specifies that domains are property subject to in rem actions, and that such actions can be filed in the judicial district in which the registrar of the domain name is located. 15 U.S.C. §1125(d)(2)(C). The in rem action may be initiated when a plaintiff cannot locate the domain name registrant or cannot obtain personal jurisdiction over the registrant (i.e., if the registrant resides in a foreign country). In such cases, a trademark holder may

proceed directly in rem against the domain name itself, with the court's jurisdiction limited to orders to delete or transfer the name. In this sense, these provisions of the ACPA seem to treat a domain name as tangible property, which is "located" in the state where it was registered by the authorized domain name registrar, and is subject to traditional in rem jurisdiction rules applied to other forms of tangible property.

The constitutionality of the in rem provision was challenged by the defendant in *Caesar's World Inc. v. Caesars-Palace.com et al.,* No. 99-550-A (E.D. Va. Mar. 3, 2000). Caesar's World Inc. filed an action against numerous domain names it alleged violated its trademark rights, in the U.S. District Court for the Eastern District of Virginia, where the registrar, Network Solutions, is located. The defendants argued-similar to the Lockheed case-that domain names cannot be considered property because they are merely data that form part of an Internet addressing protocol. The court, however, found that Congress can make data property and assign its place of registration as its situs.

IV. The Bankruptcy Alternative

A. Comparison Between Bankruptcies Under Chapters 7 and 11

Since mid-2000, the bankruptcy-avoidance pattern discussed earlier began to change, and dotcoms increasingly filed for liquidation under Chapter 7 of the U.S. Bankruptcy Code (the "Bankruptcy Code"). Subsequently, as even more Internet companies incurred difficulties, more of them began to file for protection under Chapter 11 of the Bankruptcy Code, which provides a reorganization procedure usually reserved for companies that are trying to resurrect their businesses.[**11**] As of late September 2001, most failed dot-coms that file for bankruptcy still use Chapter 7, according to statistics compiled by BankruptcyData.com, a Web site that follows bankruptcy filings across the United States.[**12**] Thus, Chapter 7 petitions accounted for 79 of the 139 bankruptcy filings made by businesses with a "dot com" in their corporate names, according to BankruptcyData. (These figures do not include the bankruptcies of many Internet businesses whose corporate names do not include the ".com.")[**13**]

Including companies of all types, only 26% of 35,323 business bankruptcy filings in the U.S. last year were made under Chapter 11, according to the American Bankruptcy Institute.[**14**] However, Chapter 11 liquidations have become more common in California's Silicon Valley. Recent cases under Chapter 11 include: Standard Media Inc., the publisher of the now-defunct *Industry Standard;* Quokka Sports, Inc., the provider of a web site for the 2000 Olympics; online grocer Webvan; wireless-Internet provider Metricom Inc.; and online software and peripheral merchant Egghead.com Inc.

Chapter 11 of the Bankruptcy Code is generally viewed as the proceeding designed for companies that plan to reorganize and continue to operate. However, it is legal to liquidate a company that is operating under Chapter 11. Accordingly, some practitioners believe that a large Internet business that does not intend to continue in business but wants to maximize the value of its intellectual property and other unique assets, should file and proceed under Chapter 11. They theorize that a higher price can be obtained under the more orderly system prescribed by Chapter 11 than under straight liquidation under Chapter 7.[**15**]

In Chapter 11, the Internet company that intends to sell its assets typically will seek court approval to pay "stay" bonuses, designed to retain key employees who can help make sure the auction of assets goes smoothly. In contrast, a Chapter 7 liquidation is handled by an impartial trustee, whose fees are set by the federal Bankruptcy Code. Because the trustee fee schedule is lower than the salaries and bonuses paid under Chapter 11, some critics allege that the motive behind such Chapter 11 deals is a desire by the management to "milk" the company's assets one last time." As a practical matter, the aggregate "stay" bonus compensation will be negotiated between

the company and its main creditors (or creditors' committee).

Thus, in the Quokka Sports Chapter 11 proceeding, some creditors argued that potential milking of the corporate assets was exactly what would occur. Management's initial bankruptcy plan proposed that 15 employees would receive a total of $239,243 in bonuses for staying on the job to help work on the liquidation process. Four other employees, including the company's former chief executive officer, were to share in a 15% commission on the proceeds received upon liquidation. Objections were filed calling Quokka's Chapter 11 "little more than an attempt by . . . management to dip one last time into a trough that already has been depleted over the last year."[16] Ultimately, the U.S. Bankruptcy Court in San Francisco rejected the proposed bonuses and commissions.[17]

Similarly, in Standard Media's Chapter 11 proceeding, the company's creditors objected to a proposed agreement that Standard Media pay 5% of its liquidation proceeds to three of its executives, including its founder, its chief operating officer, and its editor in chief. Attorneys representing the San Francisco-based company argued that the three offices provided critical knowledge and services in the Chapter 11 liquidation.[18] The unsecured creditors disputed this argument and called the 5% fee "a disguised 'golden parachute' payment to the three officers, completely unrelated to service in connection with the sale" in a brief filed with the bankruptcy court.[19]

A counter-argument in favor of selling assets under the Chapter 11 process is that it will not cost the bankruptcy estate much more than under Chapter 7, on the theory that a Chapter 7 trustee needs to hire outside contractors to help oversee an effective sales process. It is also argued that the best candidates for helping a trustee oversee an asset liquidation are former employees of the bankrupt company.

B. Privacy Issues in Insolvency or Bankruptcy

Insolvency or bankruptcy can have implications for the privacy policies of the Internet company. Thus, when the U.K. fashion site Boo.com sold its major assets, including its brand, web site, and associated intellectual property to Fashionmall.com, Fashionmall.com acquired data on 350,000 Boo.com customers with no indication of compliance with Boo.com's own privacy policies or with European Union requirements relating to customer data.[20]

Toysmart.com's bankruptcy generated even greater privacy issues. In 1999, Toysmart became a licensee of TRUSTe, a trustmark firm that certifies the quality of online privacy policies. Toysmart posted the following privacy statements on its web site: "Personal information voluntarily submitted by visitors to our site, such as name, address, billing information and shopping preferences, is never shared with a third party," and "[w]hen you register with toysmart.com, you can rest assured that your information will never be shared with a third party."[21] After creditors of Toysmart.com subsequently forced the company into involuntary bankruptcy, Toysmart sought to sell its assets, including databases and customer lists.

On July 10, 2000, the Federal Trade Commission ("FTC") filed a complaint in the bankruptcy case and sought a permanent injunction against sale of Toysmart.com's customer lists, alleging that any such sale would violate the federal FCT Act, in light of the privacy statements previously published by Toysmart.com. Toysmart.com then entered into a settlement agreement with the FTC, allowing Toysmart.com to sell its customer list to a buyer "in a related market."[22] The restrictions were, held in limbo by the U.S. Bankruptcy Judge, who ruled that restricting the sale to a particular type of buyer was premature and counterproductive.[23] Ultimately, the court approved an arrangement in which a Walt Disney subsidiary, Toysmart.com's parent, paid $50,000 to the bankruptcy creditors and the Toysmart.com customer list was destroyed.[24]

C. Bankruptcy and Intellectual Property

1. Power of Debtor or Trustee to Reject Executory Licenses

When a software developer goes into bankruptcy, a number of problems arise for the licensees of its software. A key problem is the licensees' potential loss of their license to use the software. The licensor typically gives licensees the right to use the object code, not the source code. Object code is machine-readable code, which cannot be read by humans, who read and work in "source code." However, the software licensor typically avoids giving the source code to a licensee, because the source code is viewed as protection against others abusing the licensor's intellectual property.

For purposes of U.S. bankruptcy proceedings, a license to intellectual property (patents, copyrights, trademarks, etc.) generally is deemed an "executory contract," *i.e.,* a contract that contains material continuing obligations by both the debtor and the non-debtor.[**25**] Continuing obligations of a software licensor often include the obligation to deliver updates or enhancements to the technology. Under the license agreement, a licensee may remain obligated to pay royalties or report improvements or use of the licensed technology. When the licensor files for Chapter 11 bankruptcy protection, either as debtor-in-possession[**26**] or with a Chapter 11 trustee who oversees the reorganization or eventual dissolution of the company, the debtor-in-possession or trustee has the power to assume or reject any executory contract, such as software licenses.

2. Alternatives Available to Licensees

When a software developer goes bankrupt (or if it refuses to support the licensee), the licensee needs the source code to have any hope of hiring its own programmer to fix bugs, develop new features or make any changes in the computer code the licensees are using. Under the "Intellectual Property Licenses in Bankruptcy Act," embodied in Section 365(n) of the Bankruptcy Code, a licensee has two choices once its executory intellectual property license has been rejected by the trustee or debtor-in-possession:[**27**] The licensee can simply accept rejection of the license agreement and termination of its rights to use the technology. On the other hand if it can satisfy certain requirements, it can continue to exercise its license rights, as long as it pays the royalties or other license fees as set out in the license agreement. (The licensee under the second alternative is also entitled to receive all embodiments of the licensed intellectual property, including computer software source code.)

Under the first alternative, the licensee will have the right to bring a claim for damages against the bankrupt estate, but will usually stand in line behind secured creditors of the bankrupt company. If the licensee elects to continue the license, it gives up any right to the maintenance and support which were provided for in the agreement. Even though the bankrupt licensor may elect to discontinue its performance obligations (e.g., such as maintenance and support) the licensee cannot withhold any royalties it owed the licensor to offset for any claims that the licensee has against the licensor.

Regardless of what is in the license agreement, Section 363(n) protects license rights only as they existed on the date the licensor filed for bankruptcy. One effect of this limitation is that, after a licensee of software or other IP exercises its rights under Section 365(n) to continue a license, it will not have any rights in updates, enhancements or prototypes created by the licensor after the bankruptcy filing. This result may not impact users of consumer shrink-wrap software or generally commercially available equipment, but it may severely impact a licensee which relies upon ongoing support and upgrades to make use of the licensed technology.

As a result, unless the license agreement gives the licensee the right to modify the licensed technology, the licensee will be able to use the technology only in the condition delivered to the licensee by the licensor. Any right to modify and otherwise maintain the technology upon the bankruptcy of the licensor must be spelled out in either the license agreement or, in a source code escrow agreement of the type discussed below.

3. Source Code Escrow

A "source code escrow" is one method of dealing with potential bankruptcy of the software licensor. Under such an escrow, the licensor deposits its source code in escrow with a trusted third party. The escrow agreement requires the escrow agent to not release the source code to the licensee unless certain release conditions are met. These conditions will typically include events such as the licensor's bankruptcy or failure to support the licensee pursuant to the license agreement.

4. Security Interests in Intellectual Property

Under Section 544 of the Bankruptcy Code, a trustee (or debtor-in-possession) may avoid a transfer that is voidable by a hypothetical judicial lien creditor or actual unsecured creditor of the debtor. This section often enables trustees and debtors-in-possession to avoid unperfected security interests. It also empowers them to avoid other transfers that must be recorded under applicable nonbankruptcy law in order to be valid as against a judicial lien creditor and have not been so recorded prior to filing of the bankruptcy petition.

a. Copyrights

Thus, entirely apart from rejection under section 365, discussed above, a bankruptcy filing by a licensor of copyrighted material may eliminate the rights of an exclusive licensee which has failed to record the license properly. Under the U.S. Copyright Act, a "transfer of copyright ownership" includes an assignment, mortgage, *exclusive license,* or any other conveyance, alienation or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright."[**28**] A transfer does not include a nonexclusive license. It has been held that a security interest in a copyright was not perfected by filing a financing statement under the Uniform Commercial Code ("U.C.C."), because the security interest had not been filed in the Copyright Office.[**29**] As a result, the debtor in possession (or trustee) could avoid the unrecorded "transfer of copyright ownership."[**30]**

An Internet company may sometimes sell software to a licensee under an installment sales contract which effectively divests the seller of control over the software. The Internet company then may want to generate immediate cash from the contract by assigning the right to the installments to an institutional lender. The lender in turn wants to protect against the seller's possible insolvency by "perfecting" a security interest in the installment payment. Under U.S. law, copyrights are generally deemed general intangibles.[**31**] If the security interest of the lender is not perfected by recording the transfer in the U.S. Copyright Office rather than by filing in the applicable state, as would be the case with most other forms of personal property, the lender will find itself merely an unsecured creditor of the bankruptcy estate.

b. Trademarks

Under the Lanham Act, an assignment of a trademark is void against any subsequent purchaser for value without notice unless it is recorded in the U.S. Patent and Trademark Office ("PTO") within three months after the date thereof or before such subsequent purchase.[32] Although apparently no bankruptcy case has yet addressed the effect of the failure to record a trademark license in the PTO, courts have addressed the failure to so record a *security interest* in a trademark. Because the Lanham Act provides only for recordation in the PTO of an *assignment* of a trademark, and an assignment is "an absolute transfer of the entire right, title, and interest to the trademark," it has been held that a security interest is not such a transfer and thus cannot be perfected by recordation in the PTO, but rather by filing a financing statement in compliance with Article 9 of the U.C.C.[33] Courts are divided over whether an *exclusive license* to use a trademark constitutes an "assignment" of the trademark.[34] Careful practitioners should record security interests in the PTO as well as filing under the U.C.C.

c. Patents

The U.S. Patent Act provides that an assignment of a patent is void as against any subsequent bona fide purchaser or mortgagee for valuable consideration, without notice, unless recorded in the Patent and Trademark Office within three months from its date or before the date of such subsequent purchase or mortgage.[35]

The requirement of recordation appears to apply equally to grant of an exclusive patent license, at least where it is for the life of the patent. Moreover, case law appears to treat an exclusive patent license as an "assignment," at least where the exclusive license is for the life of the patent.[36]

While apparently there is no reported bankruptcy case dealing with the effect of failure to record a *patent license* with the PTO, there is with case law holding that failure to so record a *security interest* in a patent does not render the security interest voidable by a trustee or debtor in possession in the position of a hypothetical judicial lien creditor under 11 U.S.C. §544(a)(1).[37] Again, careful practitioners should both file under the U.C.C. and record in the PTO.

5. Bankruptcy's Effect on Patent Licenses

The Ninth Circuit Court of Appeals has held that nonexclusive patent licenses are personal and assignable only with the consent of the licensor.[38] Under its ruling, general principles of bankruptcy law, which permit the assumption of contracts without regard to contractual anti-assignment provisions, do not apply to contracts for personal services, which the court reasoned under patent law is the nature of nonexclusive patent license agreements.[39] This means that a debtor-in-possession under Chapter 11 may not assume an executory patent license over the licensor's objection if applicable state law would bar assignment to a hypothetical third party, even in cases where the debtor-in-possession does not intend to assign the contract in question to any such third party. It also means that, a licensor which owns patents may effectively bar sale of the assets of an Internet company or prevent the bankruptcy trustee from operating the

company during bankruptcy.

Under the Ninth Circuit rationale, when a debtor files for bankruptcy, and creates a bankruptcy estate which includes the debtor's property interest, the debtor is no longer the licensee as the parties had originally intended under the license agreement, but rather a *new* entity, which may not assume the license without the permission of the nondebtor licensor.[**40**]

ENDNOTES

* ©Denis T. Rice

1 Laura Lorek, *Grim Reapers Prey on Dot-Com Failures,* INTERACTIVE WEEK (July 10, 2000).

2 Carol Pickering, *Boo Who?,* BUS. 2.0 (July, 2000).

3 Dan Ackman, *Top of the News: Kozmo Goes Kaput,* FORBES.COM (Apr. 12, 2001), at www.forbes.com/2001/04/12/0412topnews_print.html.

4 *Id.*

5 Randy Barrett, *Oh, What a Year!,* ZD WIRE (Interactive Week, December 28, 2000).

6 Sascha Segan, *News Site Goes Lender,* ABCNews.com (June 6, 2000).

7 Quoted in Elliot Williams, *Venture Capitalists, Unite!* at www.merger.com/press/pr_unite.html.

8 Jason Hoppin, *Bankruptcy's Quiet Boom,* THE RECORDER (Aug. 28, 2001), 1.

9 *Id.*

10 U.S. Bankruptcy Code ("Bankruptcy Code") §548. Among requirements for setting aside such a sale are (1) that the transfer was made to hinder, delay or defraud any creditor or (2) that the seller received less than fair value and either (a) was insolvent at the time (or made insolvent by the transfer), (b) the seller's remaining assets constituted unreasonably small capital or (c) intended to or believed it would incur debts beyond its ability to pay as they matured.

11 *Dot-Com Bankruptcy Filings Raise Creditors' Ire,* THE WALL S. J. (Oct. 22, 2001), B5.

12 *Id.*

13 *Id.*

14 *Id.*

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 The September 2001 auction, held a month after Standard Media' Chapter 11 bankruptcy filing, raised $1.4 million. Business 2.0 publisher AOL Time Warner Inc. paid $500,000 for a list of the *Industry Standard's* subscribers and International Data Group, Standard Media's biggest shareholder, bought the *Standard's* Web site and other assets for $900,000. *Id.*

20 Jane Winn & James Wrathall, *Who Owns the Customer & The Emerging Law of Commercial Transactions in Electronic Customer Data,* 56 BUS. LAW. 213, 226-27 (2000) ["Winn &Wrathall"].

21 Winn & Wrathall, 227.

22 *FTC Approves Pact Allowing Toysmart's Customer List Sale,* WALL ST. J. (July 24, 200) at 28.

23 Jerry Guidera and Frank Byrt, *Judge Refuses to Set Conditions on Toysmart Sale,* WALL ST. J., Aug. 18, 2000, at B6.

24 Gavin McCormick, *Judge Approves Toysmart Data Deal,* INTERNET.COM (Jan. 30, 2001).

25 *See In Re Texscan,* 976 F.2d 1269 (9th Cir. 1992).

26 In the early stages, the company itself may act as its own trustee, called "debtor in possession." The executory license contract may be rejected by the debtor-in possession or trustee.

27 Bankruptcy Code §365(n).

28 17 U.S.C. §101 (emphasis added).

29*In re Peregrine Entertainment, Ltd.,* 116 B.R. 194, 199-204 (C.D. Cal. 1990).

30 *Id.* Note that in *Aerocan Engineering Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co.),* 244 B.R. 149 (Bankr. N.D. Cal. 1999), *aff'd,* 2000 U.S. Dist. LEXIS 20687 (N.D. Cal. 2000), appeal docketed (No. 00-16550, 9th Cir. 2000), it was held that *Peregrine* only governed *registered* copyrights, and that *unregistered* copyrights were perfected by filing under the U.C.C. That is contrary to the ruling in *In re Avalon Software, Inc.,* 209 B.R. 517 (Bankr. D. Ariz. 1997).

31 Uniform Commercial Code, §9-106.

32 15 U.S.C. §1060.

33 *Joseph v. 1200 Valencia, Inc. (In re 1997, Inc.),* 137 B.R. 778 (Bankr. C.D. Cal. 1992).

34 *Compare Quabaug Rubber Co. v. Fabiano Shoe Co.,* 567 F.2d 154, 159 n.8 (1st Cir. 1977) ("15 U.S.C. §1127 provides that the term 'registrant' embraces the assignee thereof, and an exclusive licensee is an assignee"); *Ste. Pierre Smirnoff, Fls., Inc. v. Hirsch,* 109 F. Supp. 10, 12 (S.D. Cal. 1952) (the grant of an exclusive and irrevocable right to use a mark in a designated territory is an assignment and not a mere license) *with Estate of Presley v. Russen,* 513 F. Supp. 1339, 1350-51 (D.N.J. 1981) (the grant of an exclusive use of a trademark that is limited as to duration or area is not an assignment and will not confer title upon the licensee. "In principle, an assignment is permanent and perpetual, while a license is temporary, provisional or conditional").

35 35 U.S.C. §261.

36 *See Heywood-Wakefield Co. v. Small,* 96 F.2d 496, 499 (1st Cir. 1938) ("license contract" in which patentee granted exclusive right under patent to make, use, and sell invention during term of patent was an assignment); *American Type Founders v. Dexter Folder Co.,* 53 F. Supp. 602, 604 (S.D.N.Y. 1943) (agreement granting exclusive license for the term of the patent and reserving royalties to the patentee constituted an assignment and not a license).

37 In *In re Transportation Design & Tech., Inc.,* 48 B.R. 635 (Bankr. S.D. Cal. 1985); *see In re Cybernetic Svcs., Inc.,* 239 B.R. 517 (B.A.P. 9th Cir. 1999) (recordation in the Patent and Trademark Office was unnecessary to perfect security interest in patent as against the trustee in bankruptcy).

38 *In re Catapult Entertainment,* 165 F.3d 747 (9th Cir.), *cert. dismissed,* 528 U.S. 924 (1999).

39 *Id.*

40 *Id. In re Access Beyond Techs., Inc.,* 237 B.R. 32 (Bankr. D. Del. 1999), found that under patent law a nonexclusive patent license is always an executory contract requiring personal services because patent law implies an obligation on the part of both the licensor and the licensee not to sue each other for infringement.